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THE CRASH OF '87
How It Will Affect Small Private Companies
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Why Incentives Can Be Bad for Your Employees

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How to Begin Selling to Large Companies

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All the right moves—yet he nearly lost his firm

COVER PHOTOGRAPH
by
Harry Benson

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LETTERS

make: abandoning your strength to compete from a weak position against someone else's strength!

David F. Ramacitti
Marketing Consultant
David F. Ramacitti & Associates
Davenport, Iowa

WHAT MCDONALD'S MEANS

You were right on target to include John F. Love's *McDonald's: Behind the Arches* in Required Reading ("Hamburger Heaven," September). At Ugly Duckling Rent-a-Car, it is not just required reading—it's our management textbook. With thousands of franchisors already in business and the role of franchising predicted to reach 50% of the service economy by the year 2000, every top manager is given a personal copy with the warning "Questions will be asked later."

Lest an enterprising entrepreneur with a unique idea get illusions of becoming a multimillionaire from franchise royalties, consider the dilemma of Ray Kroc and others.

How do you sell and service enough fairly priced franchises to enough people fast enough to generate initial cash each month so that your royalty and initial fees will not get eaten up trying to cover operating expenses?

The franchise is probably the most effective tool invented for a low-capitalized business to expand and outrun wealthier competitors. However, the greatest danger and the most likely condition facing any fast-growing business is negative cash flow. Love's interesting explanation of how Kroc solved this problem makes it truly required reading.

Thomas S. Duck Sr.
President
Ugly Duckling Rent-a-Car Systems Inc.
Tucson

BANKERS AND RISK

It may be tempting to dismiss bankers as irresponsible to borrowers in refusing to accept risk ("Banking: Playing Hard to Get," Hands On, September), and to view the banker as an adversary who must be manipulated.

But I find much more merit in the article "How I Learned to Stop Worrying and Love Negotiating" (Executive Forum) in the same issue, in which you suggest that a person should seek to understand the needs of the other party in any transaction in order to maximize the potential of any relationship.

Banks appear to be risk adverse because they face the possibility of losing all their loaned funds while having a potential gain of approximately 1% to 2% (net return on assets employed). As any intelligent investor would do, bankers seek to keep the risk appropriate to their reward by reducing the uncertainty of repayment. Often, this uncertainty can be reduced by nothing more than a better understanding of the borrower's ability to meet the challenges of the marketplace and business cycle.

This is a complex process involving human emotion, therefore it is imperative that relationships be built on trust, patience, and the commitment of each party to try its best to understand and accommodate the goals of the other. If, indeed, the banker is not willing to uphold his or her end of the bargain, then that banker is not worthy of the effort of a psychological exercise and deserves to be abandoned in favor of the competition.

Thomas M. Nunnally
Commercial Loan Officer
First Seneca Bank
Pittsburgh

KEEPING FAITH

I agree with the point made in "Annals of Venture Capital" (Insider, September) that "Venture capital firms aren't structured to deal with their own failures. They'd rather place $10 million in new capital than spend a year fixing an old $2-million investment." It's refreshing to see the emergence of companies specifically targeting turnaround opportunities. Too often we see last year's rising star that needs nurturing passed over in favor of a fresh new investment.

Richard H. Woodhull
Principal
Sales Management Services
Washington Crossing, Pa.

CORRECTION

Last month, five companies were mistakenly disqualified from the INC. 500 list. The companies and their five-year growth rates are listed below.

☐ Genesis Travel Group, Atlanta, GA; provides travel services, 3,415%

☐ Security & Safety Consultants, Denton, TX; provides private security services, 753%

☐ M. F. Smith & Associates, Bernardsville, NJ; provides business, management, and systems consulting services, 573%

☐ Tollman-Hundley Hotels, New York, NY; owns and operates hotels, 557%

☐ TechLaw, Reston, VA; provides environmental consulting and litigation support services, 554%

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THE TRUTH ABOUT START-UPS

From cradle to grave, here are the facts about which businesses are most often started, survive, and prosper

BY DAVID L. BIRCH

So you want to start a company. (Or, if you already have, perhaps you want to start *another* one.) You are not alone.

The latest figures suggest that Americans this year will start about 700,000 new corporations, 100,000 new partnerships, and 500,000 new sole proprietorships—about 1.3 million new enterprises in all. In 1950, by comparison, there were only 90,000 new incorporations, very few new partnerships, and many fewer workers choosing to become self-employed.

That today there are so many more would-be company builders, however, doesn't mean it is any easier. If you are among them, you no doubt wonder what you could do (or where you should go) to maximize your chances for success. I get questions all the time from people just like you, particularly since at Cognetics I'm in the midst of starting a company myself.

Unfortunately, I can't help you prepare psychologically for the long hours, the endless frustrations, the constant ups and downs, the demands for patience and persistence, the desperate need to plan when there is no time for planning, and so forth.

But I *can* give you some facts about 984,000 companies in our Cognetics database that were started between 1982 and 1987 and made it through to 1987, and about the experiences of another 512,000 young companies that were started between 1978 and 1982 and tried to survive and prosper during the 1982–1987 period. Such facts as: what kinds of businesses are started most often, which ones have the greatest chance of surviving, and which ones have the greatest odds of growing significantly. I can also tell you which places tend to have the highest start-up rates, and which places tend to support growth in young companies.

Keep in mind while reading further that by each measure we ranked 236 distinct industries (the total number of industries that had at least 300 start-ups nationwide from 1978 to 1982).

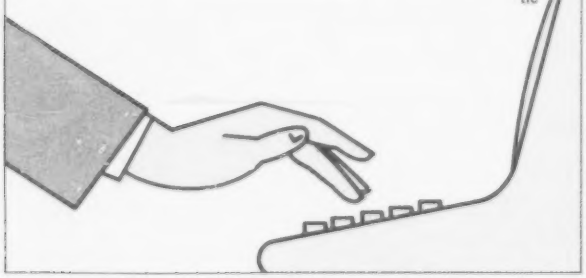
It is no surprise which businesses are most frequently started (see figure 1). Bars, small stores, and repair shops always have been common avenues for entrepreneurship. The only surprise is computer and data-processing services—an impressive newcomer at 10th out of 236. Note carefully, however, that the survival and growth rankings of the most commonly started businesses are not very high. The old adage that "Fools rush in where angels fear to tread" seems to apply to starting businesses.

Let's assume for a minute that survival,

FIGURE 1 MOST FREQUENTLY STARTED BUSINESSES

Rank	Type of industry	Survival rank	Growth rank
1	Misc. business services	132	103
2	Eating & drinking places	161	162
3	Misc. shopping goods	159	206
4	Automotive repair shops	78	210
5	Residential construction	141	171*
6	Machinery & equipment wholesalers	138	105
7	Real-estate operators	38	198
8	Misc. retail stores	100	169
9	Furniture & furnishings retailers	206	171*
10	Computer & data-processing services	163	34

*tie

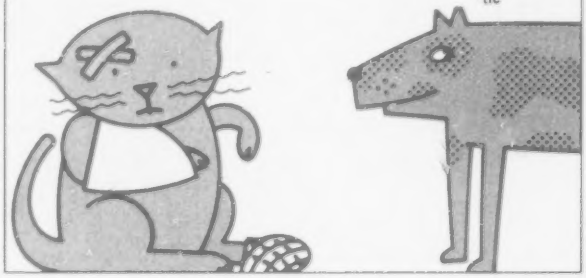


The businesses that people love to start don't score very well on survival or growth. (Total field for rankings is 236 businesses.)

FIGURE 2 BUSINESSES MOST LIKELY TO SURVIVE

Rank	Type of industry	Start-up rank	Growth rank
1	Veterinary services	125	195
2	Funeral services	158	224
3	Dentists' offices	108	171
4	Commercial savings banks	93	1
5	Hotels & motels	27	160
6	Campground & trailer parks	166	202
7	Physicians' offices	35	166
8	Barbershops	151	221*
9	Bowling & billiards places	118	186
10	Cash grain crops	197	221*

*tie



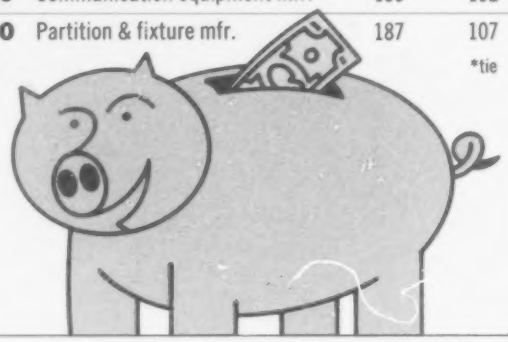
NIGEL HOLMES

Most of the businesses promising security require specialized advanced training—a formidable barrier to entry.

FIGURE 3 BUSINESSES MOST LIKELY TO GROW SIGNIFICANTLY

Rank	Type of industry	Start-up rank	Survival rank
1	Commercial savings banks	93	4
2	Electronic component mfr.	102	132*
3	Paperboard container mfr.	225	72
4	Computer & office machine mfr.	142	194
5	Misc. paper product mfr.	191	68
6	Misc. plastic product mfr.	84	132*
7	Basic steel mfr.	215	163
8	Pharmaceutical mfr.	220	172
9	Communication equipment mfr.	139	192
10	Partition & fixture mfr.	187	107

*tie



Contrary to the 'rusting of America' myth, manufacturing businesses are the most frequent high fliers.

FIGURE 4 START-UP HOT SPOTS

Places with highest start-up frequency	Places where start-ups have greatest chance of growth
1 Austin	1 Manchester-Nashua, N.H.
2 Dallas	2 Raleigh-Durham, N.C.
3 Huntsville, Ala.	3 Nashville
4 Orlando	4 Boston
5 El Paso	5 Washington, D.C.
6 Atlanta	6 S. Bend-Benton Harbor, Ind.
7 Nashville	7 Atlanta
8 San Antonio	8 Fort Wayne, Ind.
9 Charleston, S.C.	9 Orlando
10 Tampa-St. Petersburg	10 Austin

Where businesses start up often and grow fast: Austin, Orlando, Atlanta, and Nashville make both lists.

not spectacular growth, is your main business goal. You are tired of working for someone else and you would like to start a business that is likely to be around five years from now—that is, you want to worry as little as possible about failure, and focus instead on leading a comfortable, stress-free life. Become a vet—not a retired soldier but a veterinarian. Figure 2 shows that many of the most secure businesses are those that require advanced training to start—training that serves as an effective barrier to entry. The businesses of vets, dentists, and doctors are good examples.

Of course, degrees and training may buy you security and protection from other entrants (most high-survival companies rank low in start-up frequency), but, with the recent exception of savings banks, they do not tend to produce much growth. The average growth rankings for secure businesses are very poor.

If you want to be not only independent but rich, you must go after growth. Contrary to what you may think about the "rusting of America," 9 out of 10 of the industries with the highest odds of significant growth are in manufacturing (figure 3). But as you can also see, these are not the easiest businesses to get into—they have low start-up rankings. Nor would they provide restful, stress-free work environments—their survival rankings are not so good.

By this point you may be thinking that selecting a business to start is less simple than you had hoped. The businesses that seem easiest to start tend to grow little—or even to close. Those that easily survive do so because they are difficult businesses to get into. And the ones you can get rich at are hard to start and hard to keep going.

We took one last cut at the data to see if there were any reasonably easy ways out, by which we mean: are there businesses that rank in the top 50 in start-up frequency *and* survival rate *and* growth likelihood? The answer is yes. There's *one*—engineering and architectural services. So if you are good at designing buildings and bridges, you have much going for you. Otherwise, you will have to struggle.

Summing this up another way, you have to think carefully about what kind of business you want to start. None is likely to provide you with easy entry, security, and reward. You'll be forced to choose those characteristics that matter most to you, and then brave the absence of the others.

One thing you *can* do when starting your company is to locate in a place that offers a lot of support. As I mentioned earlier, starting a business is psychologically difficult. It helps to be where bankers, accountants, and financiers are used to working with start-ups, and where lots of other start-ups are around to remind you that you're not crazy.

We've observed in our data that some places are indeed much more likely than others to support the start-up and growth of young businesses—by a factor of 8 or 10 over less hospitable locales. Figure 4 ranks places in terms of start-up rate and in terms of the odds that young companies there will grow significantly. Despite all its problems (or perhaps because of them) Texas is still a major hotbed for young growing companies, although it is certainly not alone. Conversely, our data has shown that you should think twice before starting up in many of the country's rural areas. They may be peaceful, but you would be—for the most part—on your own. As we'll see in next month's column, you can do it, but it isn't easy. The figures suggest that loneliness works against, rather than on behalf of, success. □

David L. Birch is president of Cognetics Inc. and director of MIT's Program on Neighborhood and Regional Change.

TO CATCH A THIEF

Don't fool yourself—small companies are great places for embezzlers

BY STEPHEN NELSON

Few things are more discouraging to a company owner than discovering that somebody you've trusted has had his hand in the till. Yet when you start swapping embezzlement stories, as I have with other controllers and chief financial officers, you begin to realize that there are limitless opportunities in most small companies for people to steal. Often there are few procedures and controls in place—and for a reason. If you wanted to work in a big-corporation bureaucracy, you probably wouldn't have started your own company in the first place. Still, having no controls can be very costly. The fact is, embezzlers are drawn to a few weak spots that many small companies share. By concentrating on these, you can go a long way toward finding and preventing embezzlement in your company.

When managers are tempted to steal, there's often a shadowy accomplice: a messy set of books. I know of a controller in a manufacturing company, for example, who actually had the accounting records randomly stacked in two-foot-high piles around his office. He was the only person who could even hope to find anything there. One day when the president of the company was looking for something in one of the stacks, he came upon some suspicious-looking records quite by accident. When the dust settled, it turned out that the controller had given himself $40,000 worth of raises and bonuses over the course of the year.

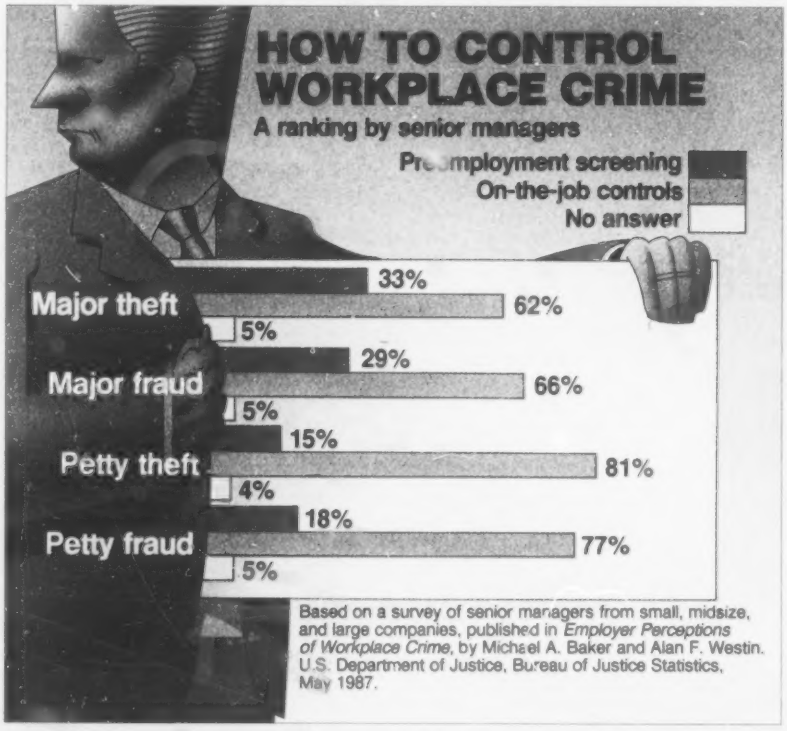
Not infrequently—and often appropriately—"clean books" as a business goal become subordinate to more urgent concerns. But your books document the financial transactions of the business, and that includes criminal transactions. And, as with any criminal, the embezzler minimizes the chances of being caught if he or she destroys or hides the evidence, which is exactly what sloppy bookkeeping can accomplish.

Most embezzlers want to, and do, work alone. Someone, for example, who is completely responsible for every step of the weekly payroll can easily add imaginary employees to the payroll, increase wages, and tinker with payroll deductions for employee benefits and taxes. Payroll, accounts payable, accounts receivable, inventory, and investment portfolios are all wonderful targets for embezzlers. It follows, then, that if you segregate duties in some key areas so that what one employee is doing, another is checking, you'll probably keep temptation at bay—it's unlikely that a potential thief could successfully enlist another employee as an accomplice. So, as a general rule, try to separate the bookkeeping for an asset or event from the physical custody of the asset or management of the event.

You'll also reduce your chances of hiring an embezzler if you closely check the backgrounds of candidates for accounting and managerial positions. In my experience, someone who has embezzled once is likely to be a repeat offender. And why not? Embezzlers are rarely prosecuted—company owners are usually too embarrassed to press charges. Some say you'll never turn up something as dirty as embezzlement with reference and background checks, but I don't buy that. Usually a lot of people know about the problem when it's being investigated—and when the embezzler is forced to leave a company. I'm thinking of the owner of a closely held research-and-development company who, in the process of dealing with an embezzler, discussed the problem with his law and accounting firms, corporate officers and directors, the bank, the investment bankers, and the investors. Plus everyone in the embezzler's department knew why she had been fired.

Now it's true that you probably couldn't make one phone call and discover that this person had been fired for embezzling. But the world's an awfully small place. Sordid news makes for great gossip, and sooner or later the news gets around no matter how quiet people try to keep it. You just have to dig a little harder than usual to uncover it.

If you follow these suggestions, it won't be easy for someone to pull a simple scam in your company. But to keep a check on exceptionally clever thieves, there's one more step you should take. Require your employees to take long enough vacations so that somebody else has to take over their responsibilities. Many of the embezzlement schemes are so fragile they require a lot of day-to-day maintenance, and they'll fall apart without it. A common example is "lapping"— whoever handles



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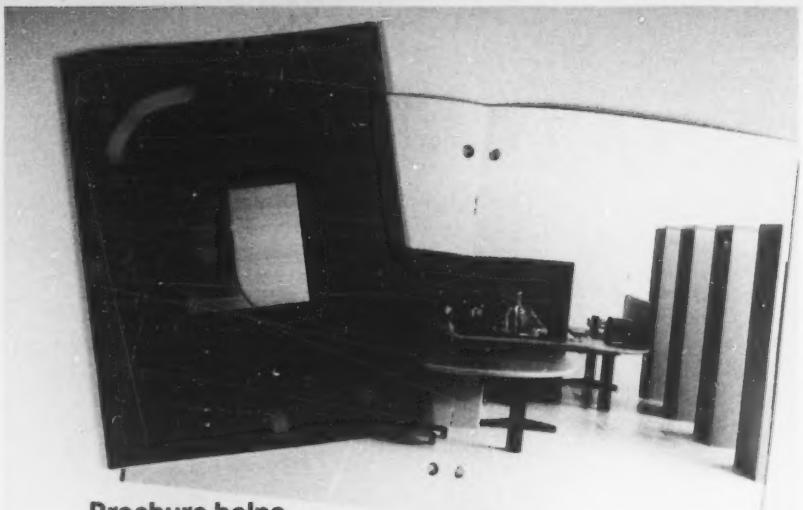

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accounts receivables skims cash off the incoming collections, and uses other collections to cover for it, in essence robbing Peter to pay for Paul.

There's another reason to require employees to take vacations. You may well notice some changes occurring in your cash flow, say, or maybe a cost line item will suddenly drop. The most extreme story I've heard along these lines was about the assistant manager of a barely profitable concessions business in Washington State, who had worked for years without a vacation or break. Then, sadly, he had a heart attack and was out for months. Profits quadrupled. Predictably, the owner took a more than casual interest in the change. He discovered that the assistant manager had several tricks for increasing his own income at the expense of the business: taking a little money out of the cash register, selling some of his own inventory instead of the owner's, and buying supplies from vendors who understood that his palms needed a little grease. The plan was simple, and it was successful for years: a little here, a little there, and never so much from any one place that somebody would notice. Until he was forced to take time off. □

EMBEZZLEMENT CHECK

There are no perfect systems for thwarting an embezzler, but a few simple steps can help

You don't have to develop elaborate systems to find and prevent embezzlement in your company. Most schemes will be exposed if you simply do the following:

1. Keep complete financial records and books.

2. Be sure the person who is responsible for the bookkeeping for an asset or event is not the same person who has physical custody of the asset or management of the event.

3. Before hiring, check the backgrounds of management and accounting employees thoroughly.

4. Require employees to take vacations.

Stephen Nelson spent three years in the consulting division of Arthur Andersen & Co., a Big Eight accounting firm, and two years as controller, treasurer, and chief financial officer of a venture capital–funded technology firm. Currently he is a certified public accountant with Douglas Pemerl Co., in Seattle.